No. 75-1260

In the Supreme Court of the United States

OCTOBER TERM, 1975

FIRST RAILROAD & BANKING COMPANY OF GEORGIA,
PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

MEMORANDUM FOR THE UNITED STATES

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Department of Justice,
Washington, D.C. 20530.

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Section 801(a) of the Internal Revenue Code of 1954 (26 U.S.C.) defines a "life insurance company" as an insurance company whose life insurance reserves comprise more than 50 percent of its "total reserves," as that term is defined in Section 801(c).

The question presented is whether the court of appeals correctly held that an insurance company, which bears the ultimate insurance risk on accident and health insurance ceded by it to another company, is required for federal tax purposes to include in its total reserves the reserves attributable to such non-life policies so as to render it ineligible for preferential tax treatment as a life insurance company. The identical question is presented in the government's petitions for writs of certiorari in *Consumer Life Insurance Co.* v. *United States*, 524 F. 2d

1167 (Ct. Cl.), No. 75-1221, and *Penn Security Life Insurance Co.* v. *United States*, 524 F. 2d 1155 (Ct. Cl.), No. 75-1285.[1]

1. The pertinent facts are as follows: Petitioner was the common parent of a group of affiliated corporations, and filed consolidated returns on behalf of the group for the years 1961 through 1964. During that period, petitioner excluded from its consolidated returns the income of a second-tier subsidiary, First of Georgia Life Insurance Company, because it took the position that Georgia Life was a "life insurance company" under Section 801(a) of the Code and therefore could be excluded from the "affiliated group" for consolidated return purposes pursuant to Section 1504(b)(2) (Pet. App. B 8a-9a).

Georgia Life was primarily engaged as an insurer of credit life and credit accident and health (A&H) policies. Such policies are generally coextensive in term and coverage with the term and amount of the underlying indebtedness, and provide a means for satisfying the indebtedness in the event of the debtor's death or disability resulting from sickness or accident (Pet. App. B 11a).

Upon the issuance of its policies, Georgia Life was required to establish reserves on its books. In the case of A&H coverage, the reserve was equal, in the first instance, to the total premiums paid in advance (Pet. App. B 12a). In order to reduce its A&H reserves, Georgia Life entered into a reinsurance agreement or treaty with its parent, Georgia Insurance, on December 31, 1961. That agreement provided that 60 percent of each A&H policy insured by Georgia Life and 60 percent of the premiums paid

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[1]We are serving copies of our petitions in those cases upon counsel for the petitioner, and a copy of this memorandum upon counsel for the respondents in those cases.

thereon would be ceded to Georgia Insurance.[2] The agreement further provided that Georgia Life was entitled to a maximum commission of 96 percent of the premiums earned on reinsured business, reduced dollar for dollar by the amount of claims paid (Pet. App. A 4a; Pet. App. B 12a-13a).

Thus, Georgia Life bore the risk of insurance on the reinsured policies in an amount up to its maximum commission. If the claims on the reinsurance in any particular period exceeded Georgia Life's 96-percent commission, Georgia Insurance was entitled to carry such excess forward against Georgia Life's commission for subsequent periods. However, during the period in question, the actual claims on the reinsured policies averaged only 22 percent of total premiums received (*ibid.*).

Pursuant to the reinsurance agreement, Georgia Insurance accrued 60 percent of the premiums paid on credit A&H policies issued by Georgia Life, and reflected an unearned premium reserve liability on its own books with respect to such premiums. Georgia Life, in turn, took a 60-percent deduction from the unearned premium reserves reflected on its own books for such A&H policies. During the years in question, this treatment of reserves under the reinsurance agreement was not challenged by the Georgia Insurance officials who conducted periodic examinations of Georgia Life's books (Pet. App. B 12a, 16a).

After deducting this portion of its A&H reserves, Georgia Life took the position that it was a "life insurance company" under Section 801(a) of the Code because the reduction of part of its A&H reserves enabled it

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[2]The agreement was later amended to provide that 70 percent of each A&H policy and the premiums paid thereon would be ceded to Georgia Insurance (Pet. App. B 12a).

to meet the requirement that more than 50 percent of its reserves be life insurance reserves. Georgia Life therefore filed returns apart from the consolidated group of which it was a member (Pet. App. A 8a-9a).

On audit, the Commissioner of Internal Revenue determined that Georgia Life's "total reserves" should have included reserves for the A&H coverage purportedly ceded to Georgia Insurance, and that it therefore failed to qualify as a "life insurance company" (Pet. App. A 9a).

In this refund suit, the district court held Georgia Life was entitled to reduce its own reserves for federal tax purposes by an amount corresponding to the unearned premium reserve set up by Georgia Insurance on the ceded share of A&H coverage, on the ground that there was a legitimate business purpose for entering into the agreement (Pet. App. B 17a). It noted, however, that the only risk Georgia Insurance assumed was that claims on the quota share of ceded A&H coverage would exceed 96 percent of the premiums thereon (over four times the average claims experience on such policies), and that even this "loss" would be recaptured from Georgia Life unless it became insolvent (Pet. App. A 13a-14a).

The court of appeals reversed, with one judge dissenting (Pet. App. A 1a-7a). It held that the economic substance of the arrangement was that Georgia Life continued to bear the insurance risk, while Georgia Insurance "for a 4% fee, provided in effect a line of credit in case periodic claims reached abnormally high levels" (Pet. App. A 4a). Since Georgia Insurance "did not bear any risks except the outside possibility of insolvency of [Georgia Life]," the court of appeals concluded that "there was no substance to the agreement as reinsurance" (Pet. App. A 4a-5a).

The court of appeals followed the decision of the Seventh Circuit in *Economy Finance Corp.* v. *United States*, 501 F. 2d 466, certiorari denied, 420 U.S. 947, rehearing denied, 421 U.S. 922, motion for leave to file a second and untimely petition for rehearing pending. In the court of appeals' view, the Seventh Circuit correctly concluded that "Congress intended * * * to charge the company *actually* experiencing the risk of claim losses with the corresponding 'reserves'—for the purpose of determining who was in the insurance business—as opposed to the loan business [footnote omitted; emphasis in original]" (Pet. App. A 6a).

2. As we have pointed out in our petitions for writs of certiorari in *Consumer Life Insurance Co.* (No. 75-1221) and *Penn Security Life Insurance Co.* (No. 75-1285), petitioner correctly states (Pet. 15) that "[a] square conflict now exists between two Courts of Appeals (the Fifth and the Seventh) on the one hand and the Court of Claims on the other, on the issue presented here."[3] Accordingly, we do not oppose the granting of certiorari with re-

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[3]In its brief in opposition (pp. 3-4), Consumer Life Insurance Company attempts to distinguish its case from *Economy Finance Corp.* v. *United States*, *supra*, on the ground that the reinsurer in its case did not retain the right to the income on the reserves. While the Seventh Circuit noted that the reinsurer "did not even retain the right to the return on the investment of these reserves" (501 F.2d at 477), its decision did not turn upon that ground but rather upon its conclusion that the reinsurer "performed a banking and clearing-house function and not an insurance function" (*id.* at 478).

Likewise, Penn Security Life Insurance Company argues in its brief in opposition (pp. 7, 12) that its case is distinguishable from the decision below and *Economy Finance* because the insurer and reinsurer here and in *Economy Finance* were owned by the same interests. However, neither the court of appeals in this case nor the Seventh Circuit relied upon the fact of common ownership of the insurer and reinsurer. Cf. *Superior Life Insurance Co.* v. *United States*, 462 F.2d 945 (C.A. 4).

spect to Question 1 of the petition.[4] However, since the reinsurance agreement in this case is essentially identical to the Treaty II arrangement involved in *Consumer Life Insurance Co.*, the Court may deem it appropriate to hold this petition pending the disposition of *Consumer Life*.

Respectfully submitted.

ROBERT H. BORK,
Solicitor General.

MAY 1976.

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[4]The petition presents a second question (p. 3) whether the court of appeals properly "overturned" the district court's finding that the reinsurance agreement between Georgia Life and Georgia Insurance served a legitimate business purpose. But the court of appeals did not dispute the district court's finding in this respect. Rather, it concluded that the question turned on whether or not the agreement served to shift the insurance risk on the underlying policies. Accordingly, there is no basis for certiorari with respect to the second question.